M. LOCAL ASSOCIATIONS OF EMPLOYEES EXEMPT UNDER IRC 501(c)(4)

1. Introduction

IRC 501(c)(4) covers two distinct kinds of exempt organizations. Organizations that promote "social welfare", such as civic leagues, were made exempt in 1913, and have played a prominent part in the constellation of tax exempt organizations. The lesser known star that is exempt under IRC 501(c)(4) is local associations of employees. Local associations of employees were added to the list of exempt organizations in 1924 (section 231(8) of the Revenue Act of 1924). The fact that these organizations have received little attention underscores the need for a discussion of their characteristics including the law that relates to them and activities that they may engage in under the law.

2. Code and Regulations

IRC 501(c)(4) provides for the exemption of a local association of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality. The net earnings of these organizations must be devoted exclusively to charitable, educational or recreational purposes.

Reg. 1.501(c)(4)-1(b) provides that the word local is defined in Reg. 1.501(c)(12)-1; the words charitable and educational are defined in paragraphs (d)(2) and (d)(3) of Reg. 1.501(c)(3)-1.

3. Definition of "Local"

The meaning of the word "local" for purposes of benevolent life insurance associations is also applied to local associations of employees under IRC 501(c)(4). Under IRC 501(c)(12) benevolent life insurance associations must be purely local in character. Reg. 1.501(c)(12)-1(b) says that an organization is purely local if its business activities are confined to a particular community, place or district irrespective of political subdivisions. It also says that if activities are only limited by state borders, a benevolent life insurance association cannot be considered as purely local in character.

In applying the definition of local under IRC 501(c)(12) to local associations of employees, the difference between such associations and benevolent life insurance associations must be considered. Although both must be "non-profit", benevolent life insurance associations and local associations of employees are quite dissimilar. A benevolent life insurance association is exempt because it engages in the business of selling insurance. A local association of employees is exempt because it devotes its net earnings to carrying out charitable, educational and recreational purposes, although it may engage in business activity.

The "local" requirement for an association of employees under IRC 501(c)(4) has to do with the location of the place of employment of the association's members. It does not relate to where the members live. The members of the association must work for an employer or employers at places of employment located in the same community. An area limited by reference to the boundaries of an entire state would not constitute a community. (Reg. 1.501(c)(12)-1(b).) On the other hand, the members of a local association of employees could work for an employer or employers at various places in different states or political jurisdictions and the association would be local in character under IRC 501(c)(4) so long as the entire area that encompassed the place of employment constituted a "particular community, place or district". It follows that an employees association that has members who work for an employer or employers at locations in different states or political subdivisions is not local in character if the area does not constitute a community. (See Hardware Underwriters and National Hardware Service Corp. v. The United States, 65 Ct. Cl. 267 (1928).) An employees association is not "local" in character if the members work at locations in different communities even if the various places of employment are branches or divisions of one employer.

4. Relationship To Employer

The Service has taken the position that an organization can qualify for exemption under IRC 501(c)(4) as a local association of employees even though its activities must be approved by an employer. (Rev. Rul. 70-202, 1970-1 C.B. 130.) Thus, exemption of an employees association is not precluded under 501(c)(4) because the members' employer can exercise a degree of control over it. However, the control exercised by the employer might be to the extent that the organization is no longer an "association of employees" within the meaning of IRC 501(c)(4). Any case in which there is a question of control by the employer other than that described in Rev. Rul. 70-202 should be referred to the National Office.

IRC 501(c)(4) says that an association of employees can be comprised of individuals who work for different employers. But note that IRC 501(c)(4), unlike IRC 501(c)(9), does not require that membership must be defined by reference to objective standards that constitute employment related common bond among such individuals. (Reg. 1.501(c)(9)-1(a)(1).) Retired employees can be considered to be employees for purposes of membership in a local association of employees under IRC 501(c)(4). (Rev. Rul. 66-180, 1966-1 C.B. 144.)

5. Application of Net Earnings

The net earnings of an IRC 501(c)(4) local association of employees must be devoted exclusively to charitable, educational, or recreational purposes. The meanings of the terms charitable and educational are the same as those found in paragraphs (d)(2) and (d)(3) of Reg. 1.501(c)(3)-1. The term "education" relates to instructing or training an individual for the purpose of improving or developing capabilities, or instructing the public on subjects useful to the individual and beneficial to the community. (Reg. 1.501(c)(3)-1(d)(3).) The word charitable is used in its common law sense and includes not only the separate enumeration of activities in IRC 501(c)(3), but it also includes activities that fall within the classification of charitable as developed by judicial decisions. Thus, IRC 501(c)(3) uses the broad common law definition of charitable which can include many kinds of activities including those that advance religion, education, science, those that lesson the burdens of government, and those that relieve poverty. It also includes the promotion of social welfare by organizations designed to lessen neighborhood tensions, eliminate prejudice and discrimination, defend human and civil rights secured by law, and combat community deterioration and juvenile delinquency. (Reg. 1.501(c)(3)-1(d)(2).) Since Reg. 1.501(c)(4)-1(b) incorporates this broad definition of charity, an employees' association under IRC 501(c)(4) can devote any part of its earnings to any charitable activity that would be compatible with exemption under IRC 501(c)(3). If a local association of employees devoted all of its net earnings to charitable activities (the term charitable encompasses the term educational), the organization could qualify for exemption under IRC 501(c)(3). Indeed, such organizations probably do opt for exempt charitable status.

6. Charitable Relief for Members

Since a local association of employees may devote its net earnings to charity a question could arise whether the members could be the recipients of this charity. For example, a local association might maintain a fund to provide grants or loans to members in time of great financial need. Is this charity? Although this type of

issue has not been addressed in the IRC 501(c)(4) area it comes up in the IRC 501(c)(3) area.

Common to all definitions of charity is the characteristic of broad public benefit (Text 342, Exempt Organizations Handbook). In addition, the class of individuals to be benefited must be indefinite and not for specific persons. When benefits are limited to members of an organization the class of possible beneficiaries must be large enough so that a public interest is served. (See Scott on Trusts 3rd Ed. 369.5) Whether the class of possible beneficiaries is large enough is a factual question. Rev. Rul. 56-403, 1956-2 C.B. 307 held that an organization that awarded scholarships only to undergraduate members of a designated fraternity was exempt under IRC 501(c)(3).

Even if the membership qualifies as a charitable class the benefits provided must qualify as charitable benefits. If most or all members are entitled to benefits as a matter of right rather than need, the benefits are probably not charitable.

An organization that is funded by an employer and claims to provide charitable benefits to employees must be looked at to determine whether the private interests of the employer are being served. An indication of serving such private interests would be that benefits are tied to a pattern of employment. For example, a requirement that the members must have worked for an employer for several years would be indicative of compensation.

Any local association of employees that claims to provide charitable benefits to its members must be examined closely and all facts and circumstances should be considered. Such an association should be referred to the National Office because of lack of published precedent.

7. Payments of Mutual Benefits to Members

Contrary to what might be thought, local associations of employees were not exempted because they provided mutual benefits to members. This is clear from legislative history. (See Hearings Before House Ways and Means Committee on Revenue Revision of 1924, 68th Cong., 1st Sess. pp. 5-12; 65 Cong. Record. Pt. 3 pp. 2905-2906(1924).) Therefore, local associations of employees that are exempt under IRC 501(c)(4) may not provide its members with life, sick or accident benefits. In 1928 a classification for voluntary employee beneficiary associations that provide such benefits was added to the list of exempt organization. Employee associations that provide such benefits may be exempt under IRC 501(c)(9). If an

organization of employees that provides life, sick, and accident benefits fails to meet the requirements under IRC 501(c)(9), it cannot qualify for exemption under IRC 501(c)(4). In Rev. Rul. 66-59, 1966-1 C.B. 142, the Service held that an organization that pays lump sum retirement benefits to its members or death benefits to their survivors does not qualify for exemption as an association of employees under 501(c)(4).

At one time exemption under IRC 501(c)(4) for social welfare organizations was considered to encompass organizations that provided mutual benefits to members and so it was irrelevant to such an association of employees whether it qualified for exemption under IRC 501(c)(4) because of social welfare or because it was an association of employees. It is now the position of the Service that organizations that are exempt as IRC 501(c)(4) social welfare organizations cannot pay such benefit to members. (See Rev. Rul. 75-199, 1975-1 C.B. 160, modifying Rev. Rul. 55-495, 1955-2 C.B. 259; Rev. Rul. 81-58, 1981-1 C.B. 331, amplifying Rev. Rul. 75-199, 1975-1 C.B. 160.)

8. Recreational Activities

Unlike charitable activities, an IRC 501(c)(4) local association of employees may provide recreational activities for its members and their families without any consideration of charitable criteria. In fact, providing the means of recreation for members is probably the primary activity of most IRC 501(c)(4) employee associations. The term recreational is not defined for purposes of IRC 501(c)(4). Webster's defines "recreation" as "refreshment of the strength and spirits after toil: diversion, play" (Webster's New International Unabridged, 3rd Ed.). Reg. 1.274-2(f)(2)(v) provides that expenditures that are deductible by employers because they are for employee recreational activities include expenditures for Christmas parties, picnics, summer outings, a swimming pool, a baseball diamond, bowling alleys and a golf course. Associations of employees exempt under IRC 501(c)(4) have been known to provide members with a club that includes a gymnasium, pool tables, bowling alleys and a campground (See Hearings Before House Ways and Means Committee on Revenue Revision of 1924, supra). They have also sponsored basketball leagues, bowling leagues, bridge clubs, golf tournaments, square dancing and holiday parties (Rev. Rul. 66-180 1966-1 C.B. 144). Clearly, one could not list all the activities that could be considered "recreational".

An activity is not recreational because it provides a convenience for the members of an employees association. For example, an association of employees that operated a bus service for its members did not qualify for exemption under

IRC 501(c)(4). (Rev. Rul. 55-311, 1955-1 C.B. 72.) Furthermore, an activity that furthers recreation indirectly may not be an exempt activity for an IRC 501(c)(4) association of employees. An organization of employees that purchased tickets to recreational and entertainment events at a discount and sold them to members at the same price was held not to be exempt under IRC 501(c)(4) as it was a cooperative buying service. The organization also provided members with discount tickets that were honored by participating businesses (Rev. Rul. 79-128, 1979-1 C.B. 197).

9. Unrelated Business

Before the Tax Reform Act of 1969, IRC 501(c)(4) organizations, among others, were not subject to unrelated business income tax under IRC 511. The Tax Reform Act of 1969 extended the tax to virtually all categories of exempt organizations under IRC 501(c), including local associations of employees. (P.L. 91-172, sect. 121(a)(1) effective 1-1-70.) At the same time an exception from unrelated trade or business was carved out for local associations of employees. IRC 513(a)(2) was amended to provide that in the case of an employees' association described in IRC 501(c)(4) created before 5-27-69, unrelated trade or business does not include any sales to employees at their usual places of employment of work related clothes and equipment and items normally sold through vending machines, through food dispensing facilities or by snack bars for the convenience of members. (P.L. 91-172, sect. 121(b)(4).) If these items are sold at locations other than the employees' usual place of employment, the sales are unrelated business (Reg. 1.513-1(e)(3).) Note that the exception applies only to organizations that were organized before 5-27-69. If an organization created after that date engages in any activity listed in the exception it will be engaged in unrelated trade or business. It seems that an organization created before 5-27-69 could begin such an activity any time and it would not be engaging in unrelated trade or business.

Remember that not all income producing activities are unrelated business. If the activity is substantially related to an organization's exempt purposes aside from the need for the income it produces, the activity is not unrelated business. Thus, for example, a local association of employees could operate a school and charge tuition without being engaged in unrelated business since the operation of the school furthers the organization's educational purpose. Similarly, if it charged members a fee for the use of a swimming pool it would be furthering a recreational purpose and the activity would not be unrelated business.

10. Permissible Activities

Neither IRC 501(c)(4) nor the regulations thereunder require that the primary activities of a local association of employees be charitable, educational, or recreational. They only require that net earnings of an organization be devoted exclusively to charitable, educational or recreational purposes (unlike social welfare organizations which must be primarily engaged directly in social welfare activities, Reg. 1.501(c)(4)-1(a)). Generally, there is no limit on the amount of unrelated business a local association of employees may carry on with its members if the earnings are devoted to exempt purposes. In the extreme case it is possible for its activities to be almost entirely other than charitable, educational, or recreational. For example, all year long an association may be operating a film developing service for its members that constitutes unrelated business. At the end of the year if it spent the income from the business operation on a picnic for its members it would be operating in accordance with the requirements of IRC 501(c)(4).

Although the primary activities of an IRC 501(c)(4) local association of employees need not be charitable, educational or recreational, they must be activities that are deemed appropriate for a local association of employees. In general, appropriate activities for a local association of employers would include recreational, charitable and educational activities and certain other activities that these organization have traditionally engaged in both at the time of the enactment of the statute and in subsequent years.

IRC 501(c)(4) local associations of employees have traditionally engaged in a wide variety of income producing activities. Items sold in stores operated by local associations of employees have included notions, clothing, luggage, hosiery, photographic equipment and items on special order. They have even operated film developing services. Rev. Rul. 66-180, 1966-1 C.B. 144 holds that a local association of employees may run a gas station. Although under the facts of Rev. Rul. 66-180 business was conducted only with members and their employer, local associations of employees have sometimes invited members of the general public to do business with them along with members. The Service has not adopted a position on the extent to which a local association may do business with the public and not jeopardize exemption. An incidental amount would be allright. If the amount is more than incidental the case should be forwarded to the National Office.

Activities may produce revenue and not be appropriate activities for an IRC 501(c)(4) local association of employees. In Rev. Rul. 79-128, tickets for

recreational and entertainment events were sold at cost by a local association of employees to its members. It was held that this activity was not a traditional activity of a local association of employees and the purpose of the activity was not to produce income to be devoted to charitable, educational or recreational purposes. Notwithstanding that the tickets were for recreational events, the Service considered the purpose of the ticket selling activity to be providing a cooperative buying service and not providing recreation.

Even if an activity is producing income, the facts and circumstances surrounding its operation may indicate that it has an independent purpose and is not just for the production of income to be devoted to exempt purposes. For example, if income generated is unreasonably small in relation to the total efforts and resources expended on a business activity, it might be concluded that the business activity is not being conducted in order to obtain income for exempt purposes. (Accord, Rev. Rul. 64-182, 1964-1 C.B. (Part 1) 186.) The same conclusion may result if a business generates a great deal of income but most of it is being kept in the business and not used for exempt purposes. If a local association of employees is primarily engaged in activities that are not appropriate under IRC 501(c)(4) it will not qualify for exemption under this section.

11. Distribution of Assets Upon Dissolution

The Service does not have a published position on whether, or under what circumstances, an IRC 501(c)(4) local association of employees may distribute assets to members upon dissolution. Although the following discussion does not constitute Service position it may provide guidance in recognizing and developing issues dealing with distributions upon dissolution. Any questions that arise should be considered for referral to the National Office.

A basic principle common to all organizations that are exempt under IRC 501(c) is that they must not be operated for profit. This means in part that they may not make distributions in the nature of dividends. It does not necessarily mean that they cannot distribute assets to members upon dissolution. The act of dissolution is not part of an organization's operations. In Mill Lane Club, Inc. 23 T.C. 433 (1954), acquiesced 1955-1 C.B. 5, the court held that the distribution of assets upon dissolution to members of a social club did not destroy the club's exemption under IRC 501(c)(7) in the year of dissolution.

Neither IRC 501(c)(4) nor the regulations thereunder prohibit a local association of employees from distributing assets to members upon dissolution.

IRC 501(c)(4) provides that net earnings of a local association of employees must be "... devoted exclusively to charitable, educational, or recreational purposes." This language is similar to IRC 501(c)(3) which requires that educational and charitable organizations be organized and operated exclusively for such purposes. The regulations under IRC 501(c)(3), however, specifically provide that assets cannot be distributed to members or shareholders upon dissolution. (Reg. 1.501(c)(3)-1(b)(4).) This requirement is reasonable in view of the fact that IRC 501(c)(3) organizations appeal to the public for tax deductible contributions and their assets may be considered as impressed with a trust for the public benefit.

Although IRC 501(c)(4) does not contain an inurement provision (a statutory provision that prohibits inurement of net earnings to any individual or shareholder) even the presence of an inurement provision does not necessarily preclude distributions to members upon dissolution. In Mill Lane Club, supra, the organization was allowed to distribute assets to members although IRC 501(c)(7) provides that earning may not inure to the benefit of any individual. It is noteworthy that the regulations under IRC 501(c)(9) specifically allow for a distribution of assets to members upon dissolution although IRC 501(c)(9) contains an inurement proscription.

While the Service has no position regarding whether an IRC 501(c)(4) local association of employees may distribute assets to members upon dissolution, in one case the Service determined that an IRC 501(c)(4) social welfare organization could distribute its assets among its members upon dissolution. It seems, therefore, that an IRC 501(c)(4) local association of employees that derived its assets from an employer or its members may distribute its assets to its members upon dissolution. If assets were contributed to it with the intention that they would be used for charitable purposes, a question of whether the organizations assets are impressed with a trust for charitable purposes could arise. If a substantial part of its assets were derived from unrelated business income, a question of whether dissolution was merely an attempt to distribute profits could be raised.